

1 THE COURT: That may be a good idea. If I had let
2 the Committee -- Let me think about that.

3 MR. KENNEY: Your Honor, I mean, regardless of
4 whether it is the Committee or a trustee, I think that needs
5 to be dealt with quickly. Thank you.

6 MR. POLEBAUM: Your Honor --

7 THE COURT: Okay, everybody's spoken, now you.

8 MR. POLEBAUM: Thank you, Your Honor. It seems to
9 me that the right solution for all of this, Your Honor, is to
10 not -- You have the debtors' commitment. It is not going to
11 investigate, prosecute, or compromise any of the claims that
12 the Committee is so concerned about. We're not going to do
13 that. What we need is the sixty to ninety-day period to try
14 to bring the business deal together on the plan with this
15 proposed plan sponsor and as part of that plan negotiation to
16 finalize the terms on which the claims that we will not
17 compromise will be pursued. I think we can do that, and I
18 think in order to allow that to happen, the Court should not
19 be pre-deciding things by granting standing or allowing Big
20 Lots' litigation to go forward.

21 THE COURT: What does standing have to do with it?
22 If I can get a commitment out of the Committee not to go to
23 court before the negotiations --

24 MR. TRAUB: You have that.

25 MR. POLEBAUM: What's left undone, Your Honor, is

1 identifying who it is who's going to be responsible for
2 reviewing all of the circumstances that led to the debtors'
3 Chapter 11 case and deciding who or against whom claims
4 should be brought. And that's something that should get
5 negotiated and decided as part of the plan of reorganization
6 not through a motion that's brought on during the Chapter 11
7 case.

8 THE COURT: Don't you credit that motion with too
9 much? The argument is that if the Committee had standing to
10 file a lawsuit then that would even the playing field in
11 negotiation. I think that's it.

12 MR. POLEBAUM: It has nothing to do with the
13 playing field, Your Honor. I mean the playing field clearly
14 has on the playing field all of these claims, and the debtor
15 has said three or four times now today, we are not going to
16 compromise --

17 THE COURT: Why do you care?

18 MR. POLEBAUM: Because we do have an interest in
19 knowing who is going to be responsible for investigating the
20 circumstances around the debtors' Chapter 11 and who should
21 be held responsible for it. And what I guess what we're
22 concerned about is that when the Court says, well, the
23 Committee has standing, does that mean that it's the
24 Committee that's going to be irrevocably appointed under the
25 plan or is that still an open issue to be decided as part of

1 the plan negotiation.

2 THE COURT: Isn't that a negotiable issue?

3 MR. POLEBAUM: Well, we want it to be a negotiable
4 issue, Your Honor. We're concerned that your ordering
5 otherwise would make it a non-negotiating issue.

6 THE COURT: I'm not ordering otherwise -- I'm
7 trying to stay out of the plan.

8 MR. POLEBAUM: And I think that's the perfect
9 resolution, Your Honor.

10 THE COURT: Okay, thanks. Anything further from
11 anybody?

12 MR. POLEBAUM: Okay. Can we go onto the
13 preliminary injunction at this time?

14 THE COURT: Yeah, let's go --

15 MR. TRAUB: Your Honor, I just want to point out
16 the debtor has no dog in this fight, and if we decide that we
17 come up with a plan we're negotiating that includes this
18 provision, we may make Your Honor very happy and file a plan
19 very quickly.

20 THE COURT: Look, unless somebody says something to
21 talk me out of it, I'm going to give you the chance to
22 negotiate but this is sort of a last chance. I don't know
23 how to measure it, whether it's sixty or ninety days, but --

24 MR. TRAUB: Does that mean that we're going to get
25 the standing?

1 THE COURT: Well, I want to think about that for a
2 minute. Let me get through -- It sounds like the standing
3 issue, which, of course, leads to allegations against the
4 insiders, which I know is a dispute -- is sort of a hang-up
5 and I guess, I don't know why, but I'll think about it.

6 MR. TRAUB: And if Your Honor heard at least the
7 United States Trustee on this deal that it has made it
8 impossible to negotiate so far.

9 THE COURT: Give me a chance to think about it.

10 MR. TRAUB: Okay.

11 THE COURT: Let's get on with the preliminary
12 injunction.

13 MR. POLEBAUM: Yes, Your Honor.

14 THE COURT: Let me ask you something. This is the
15 third time this week I've cited the case dealing with the
16 jurisdiction on the authority of the Bankruptcy Court to
17 enjoin third-party lawsuits, and I'm going to suggest that
18 you read the American Horowitz (phonetical) case, which is a
19 Ninth Circuit case. Maybe some of you have already read it,
20 but nobody has cited it. I was really looking for it, and I

21 --

22 UNIDENTIFIED SPEAKER: Is that an Oregon case?

23 THE COURT: American Horowitz, it's in 885 F2d 621.
24 A Ninth Circuit case, I don't know how it does in the Third
25 Circuit, but I -- again, it's the third time this week I've

1 mentioned it, and it's going to influence my decision on the
2 issue of the injunction. So, go on.

3 MR. POLEBAUM: All right, thank you, Your Honor.
4 The debtors are seeking to enjoin -- and Your Honor, what I
5 propose to do is I have an opening statement. I have one
6 witness, Mr. McMahon.

7 THE COURT: Any way you want to do it.

8 MR. POLEBAUM: Fine, thank you, Your Honor. The
9 debtors are seeking to enjoin further prosecution of Big
10 Lots' complaint pending a final determination of the merits
11 of the debtors' complaint on two separate theories. First,
12 Your Honor, that the Big Lots' complaint violates the
13 automatic stay because all but one of the claims asserted by
14 Big Lots are property of the estate. And alternatively, or
15 in addition to that, because prosecution of any of the Big
16 Lots' claims will dissipate the debtors' interest as an
17 insured under a debtor's and officer's policy that includes
18 the debtors as an insured party. Secondly, Your Honor, the
19 second theory on which we're seeking to enjoin this
20 litigation is under § 105 of the Bankruptcy Code, and on that
21 theory, Your Honor, we believe that we're entitled to an
22 injunction for three reasons. One, in each --

23 THE COURT: Permanent or preliminary?

24 MR. POLEBAUM: Well, here we're just here on a
25 preliminary injunction, Your Honor. And under 105, Your

1 Honor, I don't believe that would ultimately be a permanent.
2 On the first set of claims, Your Honor, that these are estate
3 causes of action, we are asking for a permanent injunction
4 because this creditor is trying to usurp for its own benefit
5 an asset of the debtors' estate, and we believe that we will
6 ultimately be able to show to Your Honor that those are
7 estate claims. So, we're only here on a preliminary
8 injunction but the merits of the case do seek a permanent
9 injunction with respect to the first part of the relief
10 requested. Your Honor, on the 105 basis, Your Honor, we
11 think we're entitled to the injunction for three reasons: to
12 prevent distraction of the debtors, to avoid depletion of the
13 debtors' insurance asset, and because the debtors' estate
14 will be harmed if the action is permitted to continue because
15 the debtors are the real party in interest. Your Honor, we
16 believe that the debtors' Chapter 11 cases hang in the
17 balance. The filing of the Big Lots' complaint has entirely
18 shifted the focus of these Chapter 11 cases from one in which
19 the parties have worked together to find a business solution
20 to these cases to one in which the parties hurl accusations
21 at each other and nobody focuses on or thinks about the
22 significant business issues that these debtors need to
23 resolve in the next sixty to ninety days, and I couldn't have
24 a better example of that than this hearing, Your Honor. If
25 the Court does not put a stop to the litigation in these

1 cases for the period of time to bring the focus back to the
2 debtors' business, prospects for these cases are indeed very
3 bleak. The debtors have requested a preliminary injunction
4 which is governed by the well-known four part test:
5 likelihood of success on the merits, harm to the debtors,
6 balance of harm between the debtors and Big Lots, and the
7 public interest. With respect to the request for an
8 injunction to enforce the automatic stay, the likelihood of
9 the debtors succeeding on the merits turns on whether the
10 claims asserted by Big Lots are property of the estate, or
11 whether the debtors' interest in its DNO insurance policy is
12 adversely affected by the Big Lots' action. Debtors only
13 need to satisfy the Court that it is likely to succeed on
14 either of those theories to satisfy the first prong of the
15 preliminary injunction test. The debtors believe for reasons
16 I will turn to shortly that they are likely to succeed on
17 both theories. With regard to the injunction request under
18 § 105, this first prong of the preliminary injunction test,
19 likelihood of success, requires the debtors to show that
20 their reorganization will be adversely affected if Big Lots
21 is permitted to continue to prosecute its complaint. The
22 debtors believe that there is an overwhelming case for
23 adverse affects on the debtors' reorganization, and I will
24 turn to that shortly as well. The second prong, harm to the
25 debtors, is the same as the likelihood of success under the

1 § 105 standard and for the same reasons, strongly weighs in
2 favor of issuing the injunction. The third and fourth
3 prongs, balance of harm and public interest, are virtually
4 uncontested in this case. Big Lots does not allege any harm
5 to it that would result from the injunction, but rather
6 spends most of its time ineffectively arguing that there
7 would be minimal harm to the debtors. The fourth prong,
8 public interest in this context, is defined as what will
9 further the debtors' reorganization. And here staying the
10 litigation is unquestionably in the interest of the
11 reorganization. Big Lots has decided to retreat from the
12 reorganization process as evidenced by its resignation from
13 the Committee and set out on its own to maximize its recovery
14 to the detriment of all of the debtors' other creditors. To
15 the extent it is successful, all other creditors are hurt.
16 The public interest favors issuance of the injunction. Now,
17 I'd like to focus on the likelihood of success aspect --
18 likelihood of success on the merits portion of the
19 preliminary injunction test, and to do that, I need to
20 provide the Court with some brief factual background. In
21 December of 2000 affiliates of Bain Capital in management of
22 KB Toys purchased the KB Toys business from Big Lots for
23 approximately \$300 million. The acquisition was structured
24 as a sale by Big Lots of its shares in Haven's Corner to a
25 company called KB Acquisition. And the purchase price was

1 paid in cash except for a \$45 million purchase money note
2 that Haven's Corner issued to Big Lots. There's another one
3 or two holding companies about Haven's Corner, and it's
4 through those other holding companies that the Bain
5 affiliated into these and management of KB owned their
6 interest in the KB Toys business.

7 THE COURT: Somehow I thought that note was 52
8 million, but it's 45?

9 MR. POLEBAUM: Your Honor, the original principal
10 amount was 45. I believe that interest has accrued on that
11 note and that's what has increased the amount.

12 THE COURT: Okay. It's the same note you're
13 talking about.

14 MR. POLEBAUM: It is the same note, yes, Your
15 Honor. In April 2002, a number of KB entities and
16 shareholders entered into a redemption repurchase and equity
17 restructuring agreement pursuant to which \$88.4 million was
18 paid to shareholders in redemption of shares and
19 approximately \$33.7 million was paid as bonuses to about 25
20 senior managers. And I will refer to this transaction as the
21 recapitalization transaction. Big Lots alleges in its
22 complaint that the money to make the payments in the
23 recapitalization transaction was obtained from the cash of
24 the various operating subsidiaries and as proceeds of loans
25 taken out by those same operating subsidiaries. Big Lots

1 further alleges that the payments made in the
2 recapitalization transaction rendered the operating
3 subsidiaries and HCC insolvent. Now, a number of the parties
4 with an interest in the case hotly dispute the causes of
5 debtors' insolvency. Fortunately, for purposes of today's
6 hearing, the Court does not need to assess what caused the
7 debtors' insolvency. Rather, what the Court needs to
8 determine is whether the debtors are likely to succeed in
9 their claims that the claims alleged by Big Lots, which are
10 based on the recapitalization transaction, are claims of the
11 estate or can a single creditor appropriate such claims to
12 its own exclusive benefit.

13 THE COURT: Can I get you to wind this up?

14 MR. POLEBAUM: Absolutely, Your Honor.

15 THE COURT: You have a witness you're going to --

16 MR. POLEBAUM: Yes, Your Honor.

17 THE COURT: I'd like to hear him. I'll give you
18 two more minutes, and then --

19 MR. POLEBAUM: Two more minutes. Well, Your Honor,
20 then what I'd like to focus on is the Delaware test for
21 determining derivative versus direct claims. And there's a
22 Delaware Supreme Court case Tuley vs. Donaldson, Lufkin &
23 Gerett (phonetical), which establishes the test, and in that
24 case, the Delaware Supreme Court said whether a claim is
25 direct or derivative turns on who suffered the harm and who

1 would receive the benefits of the recovery. And the Court
2 went on to say that in the context of a claim for breach of
3 fiduciary duty, the Chancellor articulated the inquiry as
4 follows, and I'm quoting from the case now: "Looking at the
5 body of the complaint to consider the nature of the wrong
6 alleged and the relief requested, has the plaintiff
7 demonstrated that he or she can prevail without showing any
8 injury to the corporation." That's the critical question.
9 Is, can the plaintiff prevail without showing injury to the
10 corporation?

11 THE COURT: And this case is pending, the Big Lots
12 case is pending in the Delaware court.

13 MR. POLEBAUM: Yes, Your Honor.

14 THE COURT: And the appeal would go to the same
15 court that wrote that opinion if I understand, if there is an
16 appeal.

17 MR. POLEBAUM: No, Your Honor, that --

18 THE COURT: Maybe I've got the courts mixed up.

19 MR. POLEBAUM: No, no, no. Their case, the Big
20 Lots case is pending in the Chancery Court, that's actually
21 true.

22 THE COURT: All right.

23 MR. POLEBAUM: But the debtors' position is that
24 the claims that are asserted by Big Lots is property of the
25 estate under § 541 of the Bankruptcy Code and that their use

1 of that property violates § 362. It is this Court's
2 responsibility to decide whether this is or is not property
3 of the debtors' estate.

4 THE COURT: I understand that, but you're citing me
5 a Delaware case.

6 MR. POLEBAUM: Yes, Your Honor.

7 THE COURT: That kind of lays down a Delaware rule
8 on determining what's derivative and what isn't.

9 MR. POLEBAUM: Yes, Your Honor.

10 THE COURT: Which is another way of saying what's
11 property of the estate and what isn't. But anyway, go on. I
12 --

13 MR. POLEBAUM: Does the Court have any questions as
14 to whether --

15 THE COURT: No, I really don't. I want to hear
16 your witness. I think we've got to wind this up pretty soon.
17 That's why I don't mean to be cutting you off. So, I'll give
18 you another minute, and then you can call your witness. I've
19 give you a chance to close, all right?

20 MR. POLEBAUM: All right. Well, why don't I put my
21 witness on, Your Honor, and then I'll save it for closing.

22 MR. MARWIL: Your Honor, may I make an opening
23 statement, counsel for the --

24 THE COURT: I'll give you a couple of minutes,
25 okay?

1 MR. MARWIL: Thank you very much.

2 THE COURT: You bet. And I have to, you're the --
3 your client's the brunt of the motion for preliminary
4 injunction. So, I'll listen to you.

5 MR. MARWIL: Thank you very much, Your Honor, and I
6 will try to be brief. In our papers, we made very clear what
7 we were prepared to do to try to resolve this by agreement
8 without having to come and get a court order, without having
9 to have all of the effort and the papers.

10 THE COURT: And I did read it.

11 MR. MARWIL: It was a ninety-day -- We talked about
12 this, Your Honor. We were willing to forego discovery for
13 ninety days provided we get the hundred thousand pages that
14 are already produced to the Committee that are easily
15 deliverable to our office. And to the extent after the end
16 of those ninety days -- and it sounds to me like this case is
17 going to be resolved by then, if there's anything else that
18 we're doing in the state court lawsuit that has some impact
19 on the debtor that the debtor's concerned about, we'll come
20 back and see Your Honor and get it resolved. And we can work
21 out some kind of, you know, ground rule order or ground rule
22 agreement in that regard. That's our proposal, and we got no
23 response from the debtor on that, and it seems to me that we
24 got no response --

25 THE COURT: Would you be willing to put that in the

1 form of an order?

2 MR. MARWIL: Certainly.

3 THE COURT: Okay.

4 MR. MARWIL: Certainly. Now, the debtor says that
5 there's all this distraction of management as a result of the
6 action we filed in the Chancery Court, and I would beg to
7 differ quite markedly with the debtor. The distraction, if
8 there really is any, and I'll get to that in a moment, the
9 distraction isn't about our lawsuit that is on file. There's
10 a sixty-day period to answer, file a motion to dismiss.
11 We've agreed to deal with the discovery the way I've just
12 articulated to Your Honor. The distraction is about the
13 insider defendant's desire to have our suit stayed so we
14 can't get to the motion to dismiss stage, and that's why the
15 debtor filed the instant adversary proceeding and the 105
16 motion. And this is a distraction of their own making.

17 THE COURT: What do you mean "motion to dismiss"?
18 Is there a pending motion to dismiss?

19 MR. MARWIL: Your Honor, it's been made clear from
20 Bain counsel that they will file a motion to dismiss because
21 they don't believe that they are liable. They have said that
22 the liability associated with insolvency are objective facts
23 relating to Wal-Mart. So they're going to file a motion to
24 dismiss. I think we can all take notice of that. That
25 motion to dismiss is going to take many months to work its

1 way through. That's not going to distract management. It's
2 not going to distract management in particular because
3 they've got Retail Forward to help them. They've got FTI
4 Consulting to help them. Frankly, Your Honor, Big Lots
5 doesn't want management really distracted because Big Lots
6 has a \$25 million claim on account of lease liability
7 guarantees at the operating subsidiary level in addition to
8 the \$52 million note claim that we have at HCC. So, we're on
9 both sides, okay? And this isn't about -- this is not about
10 trying to prefer a \$52 million note claim at the expense of
11 the operating subsidiary creditors. It's about getting our
12 recovery in addition to what the operating subsidiaries or
13 creditors are entitled to. And, Your Honor, we're more than
14 ten percent of that \$200 million balance at the operating
15 subsidiary level. So, what we have, is we have the debtor
16 and its management exclusively controlled by the insider
17 defendants in our lawsuit looking to have Your Honor act as
18 an instrumentality to continue the delay and deferment of
19 their liability to Big Lots and frankly, their liability to
20 the operating subsidiary creditors through the Creditors
21 Committee's motion, and that delay of that suit -- If Your
22 Honor enters a stay, we can't proceed, and we can't get to
23 that critical motion to dismiss junction, and if we don't get
24 there -- We've heard from Bain. They don't see any value in
25 the lawsuit. We're not going to settle it.

1 THE COURT: What kind of an order would you agree
2 to?

3 MR. MARWIL: We would agree to the ninety-day
4 moratorium on discovery provided we got the hundred thousand
5 pages of documents, and we would agree that at the end of
6 that ninety days if the continuation motion to dismiss,
7 whatever is happening in the state court, to the extent the
8 debtor feels that there's a problem, an impairment of the
9 debtor's ability to manage, then we would come back to Your
10 Honor and talk about it and try and get it resolved. But it
11 would not be an order that would stay prosecution of that
12 lawsuit. They've got -- Insider defendants have sixty days
13 to answer or otherwise plead. Let that proceed. Let them
14 file their motion to dismiss. Let us get going. It's
15 lawyers filing papers. It's not management filing papers,
16 and we just heard really a fundamental contradiction. The
17 debtor says February was a great month. They hit their plan.
18 Better same store sales in February based on Retail Forward's
19 plan and implementation. Now we filed our lawsuit on
20 February 9th, and I'd like the debtor to figure out how
21 they're going to explain how they did great in February with
22 our lawsuit pending, if our lawsuit created all of this
23 ruckus and interfered with management.

24 THE COURT: Is the Committee on board with this --

25 MR. TRAUB: The hearing argument makes it very

1 obvious that the debtor has no stake in these claims. The
2 reason we need standing today, if you're inclined to --

3 THE COURT: No, I wasn't asking -- We're talking
4 about the delay, and we'll get to the standing.

5 MR. TRAUB: No, I know, as far as the delay, I
6 mean, you know, quite frankly, I mean at some point there are
7 some claims where we believe that a good deal of the claims
8 that he's asserting are derivative while we believe we
9 represent all creditors and we'll deal with it. Whatever
10 Your Honor does about it, we don't need a Dutch uncle debtor
11 imposing defenses. We need to be able to be on the opposite
12 side of the table of him directly, not the debtor. The
13 debtor has no interest in it. Mr. Polebaum said he's not
14 going to investigate the claims. What has he just done?
15 He's giving his opinion as about where they belong. We're
16 supposed to do that, not him.

17 THE COURT: Well, I'm going to tell you, you do
18 agree then a sixty or a ninety day sort of a standstill
19 agreement would work.

20 MR. MARWIL: On discovery.

21 THE COURT: On discovery.

22 MR. MARWIL: Without staying the action.

23 THE COURT: And the reason that you don't want to
24 stay the action is you want him to file an answer; is that
25 it?

1 MR. MARWIL: Or a motion to dismiss and allow that
2 to proceed.

3 THE COURT: Whatever you want to file.

4 MR. TRAUB: But how could the Committee not be
5 involved in that since we -- the debtor has conceded if we
6 get the Bain defendants, that the actions are derivative and
7 they have no interest and won't do it. So if we have
8 standing, which hopefully you'll grant us today, whatever
9 happens in that lawsuit, we can protect creditors. We don't
10 need Mr. Polebaum's firm to do it. We agree -- We filed a
11 pleading that said we agree many of these claims are
12 derivative.

13 THE COURT: Besides giving you standing, what do
14 you want?

15 MR. TRAUB: That's it.

16 THE COURT: Just standing. You don't care whether
17 I impose a moratorium on discovery?

18 MR. TRAUB: If, look, letting him look at a hundred
19 thousand documents, I could care less. If he comes down our
20 office any day that he wants and looks at a hundred thousand
21 documents, makes no difference to me. If he feels that will
22 be helpful to him to understand it and it promotes a dialogue
23 which it seems is what Your Honor wants, I'm all for that.
24 What I'm not in favor of is the Bain defendants, they have
25 their own lawyers, they'll do their thing. The debtor has

1 said to you, it will not investigate or do anything to
2 compromise these claims. How could they be in the middle of
3 a lawsuit. The party that should be in the middle of that
4 lawsuit is the Creditors Committee to the extent that
5 proceeds in any way. Did we say we're going to commence a
6 lawsuit in this case? No. They're saying in that case,
7 which we need to worry about, they may move to dismiss. We
8 need standing today to protect ourselves whatever you do.

9 THE COURT: No, I understand if I give you standing
10 you don't care if I impose a standstill on discovery except
11 for the hundred thousand pages.

12 MR. TRAUB: If he wants it -- Look, we are
13 supporting -- our view is we don't want this to be a
14 distraction. If he wants to read a hundred thousand
15 documents --

16 THE COURT: We're going to let him do it. Okay,
17 that's fine. Go ahead.

18 MR. MARWIL: Your Honor --

19 MR. TRAUB: Even at that, we'd like to try to
20 reorganize that in case they --

21 THE COURT: Really, I was beyond that, but anyway,
22 go on. I didn't mean to cut you off.

23 MR. MARWIL: Your Honor, it just shouldn't be that
24 hard for us to have the kind of order that Your Honor's just
25 talking about. You know, we're addressing all the concerns

1 of the debtor really, and, you know, if there's a basis for
2 dismissal, the insider defendants will file their motion.
3 That will proceed, and with any luck, during this sixty to
4 ninety day plan negotiation period, somebody will come to us
5 with some kind of rational proposal that we'll be able to
6 negotiate and make it all go away, and I think the Creditors
7 Committee is hopeful for the same thing.

8 THE COURT: You know, I'm not sure that I can draw
9 the kind of an order that you'll be satisfied. I'm inclined
10 to stay the action -- If I'm inclined, I should say, to stay
11 the action.

12 MR. MARWIL: Your Honor --

13 THE COURT: For a limited period.

14 MR. MARWIL: The staying of the action, Your Honor,
15 is damaging to Big Lots because it prohibits Big Lots from
16 pursuing its direct claims. And let me talk about that for a
17 minute.

18 THE COURT: You mean --

19 MR. MARWIL: Well, our lawsuit is not a derivative
20 claim notwithstanding the debtor's continued use of that and
21 the mischaracterization, intentional mischaracterization in
22 their papers calling it a fraudulent conveyance action. Very
23 telling. If we were pursuing a fraudulent conveyance action,
24 we would have sued all 21 members of the management team that
25 got a bonus out of the equity distribution transaction. We

1 only sued two. The two guys that lied to us, misrepresented
2 to us and got our agreement to go along with the deal that
3 had we known the actual facts, that the company was insolvent
4 and that the basis of the solvency opinion it got were
5 projections that were pie in the sky. Had we known those
6 facts and had we been properly represented to by Feldman and
7 Glazer, we would have been able to come to a court, file an
8 injunction action then to prohibit the transaction, protect
9 our rights somehow. It was our rights and they wanted our
10 signature on the Warren (phonetical) agreement. We were a
11 creditor at the time.

12 THE COURT: I read your complaint.

13 MR. MARWIL: So, what we're doing is we're suing
14 the individuals who illegally benefitted from the deal, and
15 it's illegal because it was based on fraud and
16 misrepresentation. And because of that, Judge, Your Honor,
17 the policy that they talk about, Bain's insurance policy, by
18 the way, that they talk about, is not implicated. It does
19 not cover fraud, dishonesty, or coverage for illegal gains.
20 That is exactly what our complaint is about. If we win on
21 the complaint, absolutely, positively no coverage under that
22 policy. And to do it, Your Honor, they can't argue that the
23 debtor has indemnification obligations because Delaware law
24 prohibits indemnifying officers and directors for deceitful
25 conduct, and that's the basis of our lawsuit, is the

1 deceitful conduct.

2 THE COURT: Well, I understand. I read your
3 complaint.

4 MR. MARWIL: Okay.

5 THE COURT: And I'd like you -- You know, you're
6 free to go forward with it except I'm just trying to get
7 enough of an umbrella for a limited period of time to
8 encourage negotiations and perhaps a plan.

9 MR. TRAUB: I have a three-sentence answer.

10 THE COURT: Pardon me?

11 MR. TRAUB: Let him read a hundred thousand
12 documents, stay the action for as long as you give us to do
13 the --

14 THE COURT: Well, I think, somehow the difference
15 between staying the action and no discovery; isn't it
16 semantics?

17 MR. MARWIL: No, Your Honor. We're amenable to no
18 discovery. We're not amenable to any kind of stay of the
19 action.

20 THE COURT: Why? What do you want to do?

21 MR. MARWIL: There's no basis -- We want the time
22 period to start clicking on their answer or their motion to
23 dismiss, and when that time period clicks and it's time for
24 them to file the answer or the motion to dismiss, let them
25 file it. Nothing's going to happen to the debtor or the

1 debtor's reorganization efforts because they filed some
2 papers in Chancery Court.

3 MR. TRAUB: Then we need standing, if you don't do
4 that, because we're --

5 MR. MARWIL: And we should grant standing. The
6 picture that we ought to have coming out of here, Your Honor,
7 is standing for the operating subsidiary creditors to the
8 Committee..

9 THE COURT: Okay.

10 MR. MARWIL: Prosecution of our suit.

11 THE COURT: Okay, I think I understand where you're
12 at, but I'm not sure I understand the difference between
13 enjoining the action and enjoining discovery, but --

14 MR. MARWIL: Again, it's the clicking off of the
15 days by which there has to be an answer or otherwise plead in
16 the underlying discovery. If you stay the action, none of
17 that time elapses. If you don't stay the action --

18 THE COURT: Well, it puts you two or three months
19 behind.

20 MR. MARWIL: Indeed, and if you grant the Creditors
21 Committee standing and stay my action, then I'm even further
22 behind than the Creditors Committee, and these things ought
23 to proceed in tandem -- both actions come out of the same set
24 of facts. Our harm and our damages are direct because of the
25 fraud. Their harm and damages result from the objective

1 constructive fraudulent conveyance, and they're two totally
2 separate theories and two totally separate causes of action
3 relating to the same facts.

4 THE COURT: Okay, thanks.

5 MR. MARWIL: Thank you, Your Honor.

6 THE COURT: Go ahead, let's get on with your
7 witness.

8 MR. POLEBAUM: I would like to, Your Honor, but if
9 I could just have -- get two minutes from the Court, Your
10 Honor.

11 THE COURT: Two minutes.

12 MR. POLEBAUM: There's not -- we're not able to go
13 forward with all of the litigation that everybody wants to go
14 forward with and the Committee cannot have standing if this
15 Court wants the debtors to have a chance to reorganize. If
16 we're going to go forward with litigation and the Committee's
17 going to have standing, the debtor has requested that the
18 Court appoint a trustee. That's the debtor's request, Your
19 Honor. And if you were going to allow the Big Lots action to
20 go forward, then Mr. Traub stands up and he says, I need to
21 go forward. Your Honor, we need a period of time within
22 which we try to get all of this done, get a plan of
23 reorganization confirmed that deals with the litigation, puts
24 in a home, funds it and appoints somebody responsible to go
25 after those actions. If we can't do that, Your Honor, if we

1 can't get there --

2 THE COURT: You know, I'm not inclined to appoint a
3 trustee. I really am not.

4 MR. POLEBAUM: Well, Your Honor --

5 THE COURT: I don't have that motion. I know that
6 was an alternative that I think you briefed, but I'd like to
7 deal with -- Is there anything further?

8 MR. POLEBAUM: Yes. And I'll be brief, Your Honor.
9 On the insurance policy --

10 THE COURT: I want to say, if I appoint a trustee,
11 you're going to start all over again, and I think we will
12 have lost ground at least at this point. I really am not
13 going to give up the negotiation process, and if I appoint a
14 trustee that would be the equivalent of doing that. So, I --

15 MR. POLEBAUM: Well, Your Honor, then you can't let
16 the litigation go forward because you are not going to have
17 that negotiation opportunity unless we put all the stuff to
18 rest.

19 THE COURT: Oh, I understand that, I understand
20 that. Okay?

21 MR. POLEBAUM: But on the insurance, Your Honor,
22 just two words on that. The debtor is an insured under the
23 policy. It is insured against any loss that it suffers,
24 suffers for claims that are brought against the debtor. The
25 various offices and directors are also insureds under the

1 policy and they have a right under the policy to have their
2 defense costs reimbursed. Big Lots assumes they're going to
3 win. That is not a safe assumption. If Big Lots loses this
4 case, the officers and directors are absolutely entitled to
5 reimbursement of their expenses, and it will be very
6 expensive. And that will come out of the policy and the
7 debtor as an insured under that policy still has a right to
8 make claims under the policy but it will have been
9 diminished. And there's clear precedent in this Court, Your
10 Honor, in the Allied District case, that says that under
11 those circumstances where both the company and the directors
12 and officers are insured under the same policy and the loss
13 to the company is not hypothetical and it's not hypothetical
14 here because the company is insured as a principal for losses

15 --

16 THE COURT: You know, they lost more than the limit
17 of the policy. What is it 10 million?

18 MR. POLEBAUM: It's 10 million. Your Honor, Big
19 Lots is claiming 52 and Mr. Traub's claiming 120.

20 THE COURT: Have you read the Tachour (phonetical),
21 State Farm vs. Tachour, the Supreme Court has dealt with
22 this. I mean it stands for the principal that a low limit on
23 the policy doesn't necessarily justify or doesn't justify an
24 injunction against the world.

25 MR. POLEBAUM: It's not against the world, Your

1 Honor. It's against --

2 THE COURT: Well, against other people.

3 MR. POLEBAUM: Well, in the specific context of a
4 bankruptcy, where property of the estate's involved, I
5 believe the rule is different, Your Honor.

6 THE COURT: I'm surprised nobody cited that case,
7 but in any event, let's get on with the witness.

8 MR. POLEBAUM: Your Honor, I'd like to call Mr.
9 William McMahon, please.

10 WILLIAM MCMAHON

11 being duly sworn according to law, testifies as follows:

12 THE COURT: Would you give your full name for the
13 record and would you spell your last name.

14 THE WITNESS: William Lance McMahon, M-c-M-a-h-o-n.

15 DIRECT EXAMINATION

16 BY MR. POLEBAUM:

17 Q. Mr. McMahon, by whom are you employed?

18 A. KB Toys.

19 Q. And what is your position and what are your
20 responsibilities with KB Toys?

21 A. I'm the chief operating officer. I basically run the
22 business.

23 Q. And when did you start working for KB Toys?

24 A. About two years ago. It was in April of 2003.

25 Q. And before you started working with KB Toys can you

1 describe your prior work experience.

2 A. For three years previously, I was the president and CEO
3 of Decorative Concepts, a \$300 million company based in
4 Cincinnati that dealt with gift items and home accents.
5 Prior to that, I worked at Bain Capital for two years and
6 previous to that I was a partner at Bain & Company in Boston.

7 Q. And what is your educational background?

8 A. I had a BS/BA from Georgetown University in financing
9 and marketing.

10 Q. Okay. And when did KB Toys file this Chapter 11
11 petition?

12 A. January 14th, 2004.

13 Q. And could you please tell the Court the -- Let me ask
14 you this: Did KB Toys take any actions at the time it filed
15 the Chapter 11 case to address the financial difficulties
16 that led it into Chapter 11?

17 A. Yes, very quickly, we had plans in place within a couple
18 of days after we filed regarding the store closing process.
19 We closed nearly 400 stores. We also had plans regarding the
20 fixed costs, the general administrative costs. We had a
21 termination of nearly one hundred people within the first
22 couple of months.

23 Q. Okay, and did the debtor also arrange for financing of
24 its operations at the beginning of the case?

25 A. We did. We were successful with Bank of America and a

1 \$325 million DIP facility with an additional \$25 million
2 over-advance.

3 Q. And what actions if any did the company take with
4 respect to it's relationships with various vendors?

5 A. At the time we filed, it coincided with an annual even
6 call the Toy Fair in New York City. We had, typically pretty
7 much everyone that manufactures toys attends. The management
8 team presented to about 30 different toy manufacturers our
9 situation, kind of the elements of why we went in bankruptcy,
10 what our plans were to get out of bankruptcy. We had quite a
11 bit of explaining to do about the new DIP facility to assure
12 our vendors that we did have the financial wherewithal to pay
13 them in bankruptcy, and we spent quite a bit of time talking
14 about the beginnings of a vision to get out of bankruptcy.

15 Q. Uh-huh. Did you make any financing arrangements with
16 the other vendors?

17 A. At that time we did incorporate a trade lien program
18 which allowed the vendors to ship under the terms of the lien
19 program with even more assurance then they normally would
20 under regular financing.

21 Q. Uh-huh. And this initial period of the Chapter 11 case,
22 what period of time do you think that covered?

23 A. I typically look at the first twelve to fourteen months
24 in three phases. This first phase I would say was January
25 through April. I would call it the stabilization phase where

1 we did the store closings, had a lot of issues internally
2 with morale given some of the cost reduction and a lot of
3 external issues with the vendors in terms of (1) shipping us
4 in general, just actually shipping the goods, and (2) the
5 terms I mentioned earlier.

6 Q. Okay. So, after this initial stabilization phase which
7 you say takes you to about April or so of 2004, what was the
8 second phase?

9 A. The second phase really was after the dust settled a
10 bit, it was a bit of shock obviously to the internal and
11 external audiences of the bankruptcy. In May through
12 probably about August, right up to about Labor Day, I would
13 call it the fix-the-business stage. We tried to come up with
14 some ways to change the merchandising mix, ship the mix of
15 products to be more in target with our consumers. We also
16 were looking at a real estate strategy to change our store
17 look, to lower the overall inventory levels in the store,
18 open up the field of the store, improve the shopping
19 experience. A lot of the market research had suggested our
20 customers found the stores a bit cluttered and a bit
21 difficult to shop. So we were working on those programs.

22 Q. Okay, and did the company take any action to deal with
23 any unprofitable divisions of the company?

24 A. Yes, at that time, we had begun investigations really at
25 the end of the first phase on the internet business, KB

1 Toys.com as well as eToys.com and in that early part of that
2 second phase we sold that business to DE Shaw a New York
3 based company.

4 Q. Okay. And during this period of time -- What's the
5 approximate time frame for the second phase.

6 A. I use the bookend of really Labor Day because that
7 starts the third phase which is kind of a busy season, so
8 really May through the end of August.

9 Q. Okay, and during that second phase were there any
10 discussions with the Committee or other parties over a plan
11 of reorganization?

12 A. Yes, there were. Our high level plan and vision of kind
13 of how we were changing the shopping experience, how we were
14 going to shift the product mix as well as real estate
15 strategy of growing additional stores and strip centers was
16 well received by several investors who signed confidentiality
17 agreements. One in particular, we did actually have
18 negotiations with and eventually a term sheet.

19 Q. And what happened with that negotiation?

20 A. We did not proceed with that. It stopped in the later
21 half of that phase.

22 Q. Uh-huh, and was the Creditors Committee party to that
23 negotiation?

24 A. Yes, in fact the Creditors Committee and the company
25 worked hand in hand with that investor group. The financial

1 sponsor actually met with us jointly in New York, in which
2 case we were negotiating pretty much out loud with the
3 potential investor.

4 Q. But you say that that ended up with no deal being -- no
5 agreement being reached on terms for a plan of
6 reorganization.

7 A. That is correct.

8 Q. Okay. So after it was determined that there were no
9 available plan sponsors, where did the company focus its
10 efforts?

11 A. The company really had in its third phase, which I will
12 call the busy season, which is really, as you can imagine in
13 the toy business, September through December, we have many
14 days and weeks that are very large in sales and bigger than
15 the earlier half of the year. A lot of internal focus on
16 getting the logistics of shipping that many products into the
17 stores, our staff basically doubles at that time overall. We
18 have a seasonal staff that is quite large. So, pretty much
19 all the internal focus is on the business needs. The second
20 thing, though, we had jointly retained Retail Forward, which
21 was mentioned before. We often refer to that group as RFI.
22 Retail Forward is a retail expert that the company and the
23 creditors jointly retained. We felt that the lack of success
24 we had in getting some traction during that second phase was
25 for a lot of reasons. One of the reasons we thought is we

1 can improve our strategy, refine our strategy, and we brought
2 Retail Forward in as an expert to help us with that, and that
3 really covered the entire process through September all the
4 way through December and even into January.

5 Q. And did the company also investigate some store --
6 whether it should close additional stores during this time
7 frame?

8 A. Yes, as part of the overall process, we looked at the
9 stores on a monthly basis that were not performing up to our
10 standards. We closed an additional 163 stores in the
11 December and January time frame as a result.

12 Q. And you mentioned RFI and the company working with RFI
13 to develop new strategic direction for the company. Can you
14 describe what that plan looks like?

15 A. I mentioned the refinement of the strategy. The
16 strategy really got very particular in terms of understanding
17 our customer. One of the criticism with KB is we try to be
18 all things to all people in the past. With Retail Forward's
19 help we really focused on a core customer that liked, we
20 call, the thrill of the hunt. A customer that would come in
21 every week, every three weeks into the mall, look for a new
22 store, a new look, get excited about the bargains that they
23 saw, and that really was the crux of the difference of the
24 shopping experience. And along side that we had changes in
25 the product mix, changes in the store signage, even changes

1 in some of the associate training as a result.

2 Q. Uh-huh. And when did the company begin rolling out this
3 new look for the store?

4 A. We had a lot of discussions with Retail Forward. As you
5 can imagine, in December, around the Christmas time, our
6 stores are pretty much full to the ceilings. Don't tell the
7 fire marshall that, but the time really wasn't right to make
8 the changes to the store during December. So, we really
9 started to do that in January right around mid-January and
10 completed that at the end of January. So, February 1st is
11 when the stores finally had what Retail Forward would call
12 our new look.

13 THE COURT: You're talking about February. This --

14 THE WITNESS: Just recently, yes, Your Honor.

15 BY MR. POLEBAUM:

16 Q. And I'm going to ask you about the operating results
17 with that new store look, but before I get that, could you
18 just summarize for the Court what the operating results were
19 for fiscal year 2004 ending in January of 2005?

20 A. Yes. Our fiscal year does end January 31st, so we just
21 completed about a month ago, fiscal year 2004. We lost
22 roughly about \$40 million in our operating earnings, I
23 believe \$38, \$39 million was mentioned earlier. That's about
24 the approximate amount for operating loss. We were
25 disappointed overall by the sales performance in November and

1 December which led to that.

2 Q. And why do you think the company fell so far short of
3 its sales in November and December of 2004?

4 A. There are a lot of reasons. If you look at the retail
5 business, one of the things a lot of people underestimate is
6 how far in advance decisions are made. We actually start
7 making decisions and are making decisions today. As an
8 example: February, March, and April for decisions for
9 November and December product. We start buying our product
10 from China and other sources. It takes quite a bit of time,
11 so I think one of the issues we had was we were stuck with a
12 lot of product and a lot of decisions in the November and
13 December time frame last year that were tainted somewhat by
14 the early phase, that first phase of bankruptcy. One of the
15 challenges I mentioned is we had a real difficulty in getting
16 shipments in the early part of the bankruptcy, but we also
17 had a challenge in even having discussions with vendors about
18 the longer term supply product for that fourth quarter. The
19 second thing, just quickly, is the market overall has been
20 well documented. The toy industry did suffer during that
21 fourth quarter overall. A lot of people believed the toy
22 industry was down anywhere from four to six percent for the
23 year.

24 Q. Now, during this third phase that you're talking about,
25 you've described to the Court some store closings. You

1 described the work on the new business plan with RFI. Did
2 the company also have any plan negotiations with any parties?

3 A. Yes, we did. We had discussions with Angelo Gordon, one
4 of the claims traders that was presented earlier.

5 Q. Uh-huh. And did the company negotiate a term sheet with
6 Angelo Gordon?

7 A. We did. We actually did reach a term sheet with
8 jointly, again, negotiating with the Creditors Committee and
9 Angelo Gordon.

10 Q. And what did the -- Was the company able to move forward
11 with that term sheet?

12 A. Angelo Gordon expressed some concern, and that time
13 frame was the end of October, expressed some concerns about
14 the company's performance going into November and December
15 and elected to wait and see how the year progressed in those
16 two months.

17 Q. And was its concern based on the fact that the company
18 was not attaining its sales forecast?

19 A. Yes, they were concerned that we had not kind of proven
20 out that our model was working.

21 Q. And when you were negotiating with Angelo Gordon, did
22 you provide Angelo Gordon with financial information?

23 A. We did. We provided them with historical information as
24 well as up-to-date kind of the weekly financial information
25 as well as projections going forward.

1 Q. I'd like to go back now, to the RFI business plan, which
2 you say you started implementing in January of '05 and fully
3 going forward in February 1 of '05. What have been the
4 initial results of that new marketing program?

5 A. They've been quite positive. Actually, even the stores
6 started to implement in the middle of January we saw
7 immediate results. The simplistic way to think about it is,
8 we literally took the top shelf of the store and took the
9 inventory off the top shelf and replaced it with bright
10 signs, whether they were signs of children playing with toys,
11 blue skies and clouds, and a lot more lifestyle shots. We
12 also -- I mentioned cleaned up the overall stores to improve
13 the shopping experience. Really from the middle of January
14 through today, we have experienced numerous positive days,
15 which was quite unusual for us in the last eighteen months.
16 And year to date, on this fiscal year, we actually are
17 positive in toy comps about three or four percent.

18 Q. And overall sales?

19 A. The overall sales are slightly positive as well.

20 Q. And when was the last time that the company was able to
21 achieve overall positive comps?

22 A. It's been about eighteen months. My recollection it was
23 around June, about eighteen months back.

24 Q. And did the RFI business plan include changes, regular
25 changes in the stores?

1 A. Yeah. Probably the most exciting thing, in fact, we
2 just had a company-wide meeting yesterday in Pittsfield, we
3 have seventeen store sets. The way to think about that is
4 when you walk by a store, what does the store look like?
5 What would be your two or three quick impressions? What the
6 store colors are? What items do you see in the front of the
7 store? What messages you see? Is it a buy-one get one-free?
8 Or in case of right now, there's a promotion called the two-
9 for sale. Two for \$5, two for \$10, and two for \$15. We have
10 planned out the entire calendar year. That are seventeen
11 store sets so you can imagine that they pretty much last a
12 roughly three weeks. The store looks very different. We are
13 on our second store set as an example. Over the next ninety
14 days we'll have four more store sets. The customer will see
15 that difference, but probably most importantly as a company,
16 we actually are now planning a product to flow according to
17 those store sets. We are purchasing our signs and planning
18 our signs and displays that much further out in advance, and
19 even our vendors have started to rally around us. The toy
20 fair I mentioned in January, again we just had one recently,
21 we have vendors who are making special packaging of special
22 products knowing about certain toy -- certain store sets. So
23 they will even refer to it in your Summer Sizzle store set in
24 June, we are going to ship you this product just for thirty
25 days. This is unprecedented for KB to have that kind of

1 planning, that kind of organization, all part of that Retail
2 Forward strategy.

3 Q. All right, now, coming out of the 2004 holiday season,
4 the company missed its sales plans and did the company assess
5 its operating position and its ability to continue operating
6 in 2005?

7 A. Yes, we did, if you're referring to our overall
8 financial liquidity. That was a part of the analysis that we
9 did both internally with the Creditors Committee.

10 Q. Yes, the overall liquidity --

11 A. Yes.

12 Q. -- is exactly what I wanted to ask you about. And did
13 you share that with the Creditors Committee?

14 A. Yes, we did. We had numerous discussions about our
15 ability to finance the year 2005 with the current assumptions
16 that were in the plan that were all called the Retail Forward
17 plan, that was agreed to with the Committee as a good plan
18 for the year 2005.

19 Q. The business plan was a good plan. Did the Committee
20 have concerns about the liquidity of the company?

21 A. Yes, they did. They actually liked the plan. I think
22 they jointly supported the plan, but they did have some
23 concerns that the sensitivity analysis around the plan be
24 looked at, and they asked us to look at three different
25 conditions: sales, margin, and the terms that were given to

1 us by creditors.

2 Q. And if you were sufficiently negative on one or more of
3 those factors, would the company then have liquidity
4 problems?

5 A. Yes, the scenario that they asked, there really was one
6 specific one which was missing sales by about ten percent,
7 missing margin by about four or five hundred basis points,
8 and having the terms that were given to us by the trade be
9 reduced by about fourteen days. If all three of those were
10 to happen, we did have a liquidity shortfall of about \$20 to
11 \$30 million.

12 Q. And so, did the Committee express the concern that the
13 company might need an addition \$20 to \$30 million in order to
14 operate in 2005?

15 A. Yes. In order to think about comfort with the plan, but
16 also a financial downside to the plan. They articulated that
17 it would be good for the company to find (1) a group that
18 could help finance the plan going forward, and (2) would be
19 willing to give you some kind of cushion order in magnitude
20 to \$20 to \$30 million.

21 Q. Okay. And what has the company done to try to address
22 it's situation in 2005?

23 A. We tried to address those issues directly, given that
24 they were very well stated as the two major issues with the
25 Committee. We are in negotiations currently with four banks.

1 That process started at the company, started several months
2 back, and we now have preliminary term sheets from I think
3 three of those four banks for financing the company going
4 forward in the next year.

5 Q. And do those term sheets provide liquidity over and
6 above what's available under the current financing?

7 A. They do provide additional liquidity, but it's anywhere
8 from \$4 to \$8 million. We still would need additional
9 liquidity to cover that \$20 to \$30 million. In that regard,
10 we have been talking to a financial investor, the plan
11 sponsor we referenced earlier today and made that a specific
12 request as part of any plan.

13 Q. And so could you -- Why don't you tell us a little bit
14 about that plan sponsor and the negotiations with that plan
15 sponsor. Has the plan sponsor proposed a term sheet?

16 A. Yes, we are in negotiations with that plan sponsor as
17 well as with the Committee. As Mr. Traub mentioned, this is
18 not the first time we've spoken with this sponsor, potential
19 sponsor, so they have come back to us several times and now
20 we're in negotiations with a number of details including the
21 -- what we'll call the over-advance, which would be that
22 liquidity issue of \$20 to \$30 million. They have made
23 suggestions how they might be able to bridge that gap given
24 a downside scenario.

25 Q. Have they specifically offered to provide the financing

1 needed to cover that gap if it should occur?

2 A. Yes, they absolutely have offered it, and we are jointly
3 in discussions with the Committee and with the proposed
4 sponsor and to how the mechanics of that would work.

5 Q. Okay. Are there any other options available -- let me
6 put it this way: You've mentioned financing options that are
7 available to the company from a variety of financial
8 institutions. You've mentioned the plan option that's
9 available to the company where the sponsor would propose to
10 provide that liquidity. Are there any other options that are
11 available to the company?

12 A. Yes, there's really -- there are probably two big
13 options in addition to a plan. One would be another
14 additional loan, probably a traunch C loan, is how we would
15 characterize it. We have been speaking with a group that
16 would be willing to provide that. That would most likely
17 result in the company staying in bankruptcy and trying to
18 turn itself around, but that loan would provide the
19 additional liquidity of that \$20 to \$30 million.

20 Q. And has the company received the term sheet proposing
21 that type of traunch C loan?

22 A. Yes, we have.

23 Q. When you say, "traunch C loan", could you just describe
24 what you mean by that?

25 A. It's basically just a way of thinking about the order of

1 which the loans have seniority. The bank loan that provides
2 us with our revolving credit to buy merchandise would be the
3 senior bank loan, and then a loan below that would be
4 characterized as a, you know, the traunch B and then the
5 third loan, the traunch C would be the last to be paid.

6 Q. Uh-huh. And is there any third option that's available
7 to the company?

8 A. I think there is obviously if you applied a personal
9 preference, we would like to have the plan done, but
10 certainly there is still the option that it's been mentioned,
11 which is the company could be sold in pieces in a 363
12 auction.

13 Q. Okay. And what is the time frame in which you expect to
14 reach a conclusion on whether terms for a plan of
15 reorganization can be finalized?

16 A. Realistically I think sixty to ninety days would be the
17 right time frame to finish the discussions and the
18 negotiations and see whether or not we do have a plan and
19 whether or not the sponsor would be able to agree to the
20 detailed negotiation topics.

21 Q. And is that also the time frame within which you think
22 decisions need to be made as to whether the company can
23 operate with its liquidity resources available to it?

24 A. Yes. You learn a lot. In the next sixty to ninety
25 days, we will have obviously clarity on this potential

1 sponsor. We would also understand a lot more about the other
2 two options that we mentioned, and we would have a high
3 degree of visibility under the liquidity profile of the
4 company for the remaining calendar year.

5 Q. Who are the individuals that constitute the senior
6 management team of KB Toys?

7 A. There's a team of five: Michael Glazer (phonetical),
8 the CEO; myself as COO; Rob Feldman (phonetical), chief
9 financial officer; Ken Grady is our general counsel as well
10 as executive vice president of administration; and Sal Vasta
11 (phonetical) as our executive vice president of
12 merchandising, our chief merchant.

13 Q. And what are Mr. Feldman's responsibilities?

14 A. As chief financial officer, he handles the basic
15 financial duties of any -- typical of any company, of
16 finance, accounting, treasury, dealing with the banks, but he
17 also has in his responsibilities the information technology
18 group reporting to him as well as the distribution network
19 reports to Rob as well.

20 Q. And could you tell us what the responsibilities are of
21 Mr. Glazer.

22 A. Mr. Glazer as CEO has the -- again, a fairly typical
23 slate of duties. All things that -- all the high level
24 strategic issues that I deal with whether it's in product or
25 merchandising, real estate questions, most of those issues

1 are Mr. Glazer and myself dealing with and on occasion with
2 Mr. Feldman as well.

3 Q. And who are the members of the Board of Directors of KB
4 Toys?

5 A. Mr. Glazer and Matt Levin and Josh Beckenstein
6 (phonetical) from Bain Capital.

7 Q. Okay. And so when you say from Bain Cap is that both
8 Mr. Levin and Mr. Beckenstein?

9 A. Yes, it is.

10 Q. And do you know Brian Murphy?

11 A. Yes, I do.

12 Q. And who is he?

13 A. Brian Murphy works for Bain Capital. I believe his
14 title is also executive vice president.

15 Q. And does he have any involvement in this case?

16 A. Yes, Brian is quite involved with the business day to
17 day. He's basically our liaison to Bain Capital and bit of
18 an advisor to the company as well.

19 Q. Does Mr. Murphy keep up to speed with the financial
20 performance of the company?

21 A. Yes. The five members I mentioned earlier of management
22 form what I call an Executive Committee, and Brian Murphy
23 speaks with each of those five members on a regular basis if
24 he has questions about how sales are doing, what new
25 promotions we might be doing, or certain financial issues he

1 could speak directly with any members of that Executive
2 Committee.

3 Q. And in addition to the operating part of the business,
4 does he also -- is he also involved and aware of the various
5 strategic options available to the company?

6 A. Yes, definitely.

7 Q. And do you know whether he reports his knowledge and
8 information to the members of the Board?

9 A. Yes, I know he does on a regular basis.

10 Q. Okay. Now, you mentioned an Executive Committee; can
11 you describe the responsibilities that Committee has?

12 A. Yes. About a little over a year ago, when I was made
13 chief operating officer in October of 2003, one of the first
14 things I did was formed a weekly meeting with the five
15 executives including myself. We address issues that would
16 typically come up to a company at very high levels. They may
17 be legal issues to deal with the issue of the day, but large
18 scale challenges we might have whether there's some product
19 or promotions, financial issues, human resource issues, and
20 general strategy of the company is directed by that
21 Committee.

22 Q. And are Messrs. Feldman and Glazer participants and
23 members of that Executive Committee?

24 A. Yes, they are.

25 Q. Now, in your earlier testimony, Mr. McMahon, you

1 described various overhead reduction initiatives that the
2 company has taken, can you summarize the size of those
3 overhead reductions?

4 A. I think the simple way to think about it is we were
5 about \$58 to \$60 million of fixed costs at the time we filed.
6 That run right now is closer to \$36 million. So about a one-
7 third reduction in the overall fixed costs. From the people
8 point of view, we have about 140 people have been terminated
9 from the Pittsfield office. That original base was about
10 480, and in the field we have, basically have the size of the
11 organization in the field which has resulted in terminations
12 of about 50 to 60 people.

13 Q. And the reductions in the staff at the home office, has
14 that resulted in any reallocations of responsibilities?

15 A. Yes. These changes were a necessity given our overall
16 re-sizing of the business. We have half the business, just
17 as a reminder, Your Honor, we have half as many stores as
18 when we filed, roughly 650 stores. The duties that people
19 have had to do, people have had to pick up additional
20 responsibilities. We've been unable to kind of rehire in
21 those positions sometimes because of costs, sometimes we've
22 just been unable to find people.

23 Q. And has that resulted in Messrs. Feldman and Glazer
24 having to take on additional responsibilities?

25 A. Yes. I think an example would be with Mr. Feldman, he's

1 lost a few people, his controller and other senior people in
2 finance. We also lost a senior vice president in
3 distribution, and we've had to change the vice president of
4 information technology. In each of those cases, Mr. Feldman
5 has had to take on additional duties. I've been unable to
6 get him additional resources that I mentioned for both costs
7 reasons and just the ability to find someone.

8 Q. And had Mr. Feldman and Mr. Glazer participated in the
9 various discussions and meetings with the Creditors
10 Committee?

11 A. Yes, all three of us have attended the Committee
12 meetings on a regular basis, actually many of the five of us
13 have, but consistently the three of us have attended those
14 meetings as well as any additional meetings relevant to
15 restructuring the company.

16 Q. So, if you meet with -- for example, have there been any
17 meetings with Sun -- have there been any meetings with the
18 potential plan sponsor?

19 A. Yes. In each of those meetings, Mr. Glazer and I have
20 attended and in some cases Mr. Feldman as well, but in all
21 cases Mr. Glazer and I have attended.

22 Q. And do Mr. Feldman and Mr. Glazer play an important role
23 in those strategic discussions?

24 A. I would say, yes, very much so. I've only been with KB
25 for two years. I do have over a decade of experience in

1 consumer products, but not all in retail. Their combined
2 experience in retail and understanding of KB Toys has been
3 invaluable in those meetings.

4 Q. And if Mr. Glazer, Mr. Feldman were required to spend
5 time on litigation related to the recapitalization
6 transaction, do you believe that would detract from their
7 ability to perform their responsibilities?

8 A. I believe it already has, quite honestly. There have
9 been times when I have had business-related issues that I
10 would go down at, you know, 9:30 and look for a meeting with
11 Mr. Feldman or walk across the hall to meet with Mr. Glazer
12 and they've been behind closed doors dealing with attorneys
13 regarding all the issues that we're discussing today. It
14 already is a distraction to them.

15 Q. And if those gentlemen were continued to be distracted,
16 could it adversely affect the company's ability to implement
17 its business plan successfully reorganized?

18 A. I would say, again, yes. As I mentioned, it's already a
19 distraction, and you have to remember that we as the three
20 senior executives of the company are very visible to the
21 remaining group within Pittsfield, and people are noticing
22 the distraction of those two executives.

23 Q. Does it also affect your daily routine?

24 A. It does. I don't have a day that goes by that I don't
25 have to kind of read some motion, some filings. I typically

1 get in the office between 7:30 and 8 o'clock in the morning.
2 I typically look of the sales reports by store, by region. I
3 look at different product categories that have done well for
4 the previous day. As an example, the last three or four
5 working days, I spent between 7:30 and 9 o'clock reading all
6 the various court filings to make sure I was well prepared.

7 Q. And has there been any effect on the general work force
8 in the home office from this litigation?

9 A. Yes. As chief operating officer, virtually everyone
10 kind of reports up through me. I have on any given day four
11 or five people of various levels from vice president down to
12 the, you know, lower level management, and everyday a person
13 coming into my office with concerns about how this litigation
14 or potential litigation would affect the company, and most
15 importantly they typically ask how it will affect them.
16 They're not always logical about that, but their emotion does
17 have to be dealt with given that we've lost a lot of key
18 people in the last six months, and we can't afford to lose
19 people even if it's for an irrational reason.

20 Q. And these are actual effects that have already occurred;
21 is that correct?

22 A. Yes. We lost -- Last week I lost my vice president of
23 store operations, someone who was probably referred to
24 internally as Mr. KB. A great attitude, a sparkplug of a
25 personality, and he was not actively looking, but he cited to

1 me the uncertainty of the case and said it was absolutely
2 exacerbated by the distractions and the issues regarding the
3 litigation.

4 Q. But don't you think all of this will -- all that
5 distraction will just blow over after the initial noise about
6 the litigation?

7 A. I would say not. I think -- It's a company that I would
8 characterize, people are on edge. People are basically have
9 their antenna out very high waiting to hear anything, and
10 whether it's an article in the local paper, again, just a
11 reminder, Pittsfield's a very small town. We are a very
12 large employer there. Or if they read something on the
13 internet. Nowadays, with technology, everyone has the
14 ability to do a Google search or a Yahoo search based on a
15 key phrase and every time something is mentioned, even if
16 it's a very innocuous article, if it says something in the
17 title about KB Toys and bankruptcy or lawsuits, they will
18 read it, and they will become anxious.

19 MR. POLEBAUM: I have no further questions, Your
20 Honor.

21 THE COURT: We're going to take about a ten minute
22 recess at this time.

23 (Whereupon at 3:20 p.m. a recess was taken in the
24 hearing in this matter.)

25 (Whereupon at 3:37 p.m. the hearing in this matter

25 Q. Was it successful?

1 A. Yes, I believe so.

2 Q. Have you gotten all the credit that you can possibly
3 need in the case, the full term of your projection? In other
4 words, you had a projection early on in the case, you needed
5 a certain amount of days' credit. With this program you did
6 meet that amount of credit during the season; correct?

7 A. The credit terms we are achieving are on our plan, yes.

8 Q. Okay. Was it your stated intention numerous times --
9 One other thing. Do we meet every month?

10 A. We meet on a regular basis. There's given calendars.
11 It's not necessarily every month, but pretty much every
12 month, yes.

13 Q. And we speak on a regular basis about various issues
14 going on in the case?

15 A. The attorneys speak on a regular basis. The company
16 executives don't typically speak with the creditors'
17 attorneys. We speak with the Creditors Committee members but
18 not with the attorneys.

19 Q. Would you say it's an active committee?

20 A. Yes.

21 Q. And what is -- Did we have a disagreement earlier on the
22 case about when the company should emerge from Chapter 11?

23 A. I don't know if I understand the question.

24 Q. Did you take the position that you thought the company
25 should emerge from Chapter 11 in the fall of 2004?

1 A. Yes, when we talked about the potential sponsor we did
2 indicate we thought that would be a viable plan and a
3 reasonably good time to come out.

4 Q. And even after the sponsor went out, wasn't it your view
5 that you should try to emerge from Chapter 11 in November of
6 2004?

7 A. I'm not too sure, again, I understand. When you say --
8 You're asking for an opinion was it a good time to come out
9 in November?

10 Q. Was it your intention to come out of Chapter 11 in
11 November of 2004, which was the last exclusivity extension
12 before this one?

13 A. We had discussions with Angelo Gordon, as I mentioned
14 earlier, in October, and the intention of doing a plan with
15 Angelo Gordon was at that time, yes.

16 Q. And during that period of time from the time you started
17 in Chapter 11 until around that time, would it be fair to say
18 you gave us no less than four different business plans?

19 A. Again, could you repeat the time reference?

20 Q. Between the time you filed for Chapter 11 and November
21 of 2004, did you give us not less than four different
22 business plans that you felt the company could reorganize
23 under whether it was through a plan funder who we didn't work
24 out with or Angelo Gordon?

25 A. The term "plan" is a dangerous term just because of the

1 way we reference our budgets and our business plan, how we
2 operate our day-to-day business. So, the business, our
3 business performance in each of those different times that we
4 had discussions with various potential sponsors had changed
5 at that time, so, we had to update those financials and
6 therefore, the forecast going forward would change, if that's
7 what you're referencing --

8 Q. No, I'm not.

9 A. -- that did change.

10 Q. What I'm suggesting is, that as you were determining --
11 you were taking the position that the company should emerge
12 from Chapter 11 early on, you presented several three-year
13 business plans which would have gone to the viability,
14 feasibility to the Committee. Would you say there was at
15 least two of those?

16 A. Well, with each case that we had a plan we had one. So
17 in the case of the sponsor we mentioned in that June/July
18 time frame, then later on in October, yes, there were
19 separate plans that were revised based on our knowledge at
20 the time.

21 Q. And in the November time frame, did we tell you that we
22 would not extend exclusivity any further unless we brought in
23 somebody who could help devise a business plan that we
24 thought was achievable?

25 A. I don't know about the specific timing. I know we did

1 jointly agree to bring in Retail Forward, which I believe was
2 before that time.

3 Q. Did we make the suggestion to you that we needed an
4 outside plan consultant and you agreed to that?

5 A. It's hard to remember who actually said the first point.
6 I think that we had, as you mentioned, pretty regular
7 contacts, so we did agree jointly that bringing someone in
8 from the outside and I think we had a very good discussion
9 was my recollection as to the type of person that would be --
10 the type of group that would be.

11 Q. Don't you recall that we originally said that unless you
12 could agree, we could come to somebody who would help you
13 devise a business plan. We'd like to have somebody come in
14 with hiring and firing powers because you hadn't been able to
15 achieve any of your other business plans? Do you recall
16 that?

17 A. I recall that the Committee mentioned that they were not
18 satisfied with the pace of the changes and the success to
19 date, and they said an outside group should be brought in and
20 that you would probably not support a plan going forward
21 unless such a group was brought in, and we did bring that
22 group in.

23 Q. Had you gone forward with either of the business plans
24 that were developed, any of the business plans that were
25 developed before we agreed on Retail Forward, would you have

1 made those business plans as you sit here today? Would you
2 have achieved them or would you have failed to make them?

3 A. Well, that's a hypothetical question that I --

4 Q. Well, you know what the business plan said. You know
5 how you did, so you would have failed; right?

6 A. I don't know. With all due respect, if one of the
7 sponsors in particular which owns about twelve other
8 retailers had purchased us, it's hard to say what they would
9 have done differently and what ideas, what changes, what
10 investments they would have made, so I can't answer. I don't
11 know.

12 Q. Point in fact, didn't you revise your business plan in
13 December -- after December's results so that we could try to
14 have a conversation with you guys about whether or not we had
15 a viable plan? Didn't you revise it right after Christmas?

16 A. Yes, we revised our plans pretty much every week in
17 terms of --

18 Q. I'm talking about emergence plans, plans that would form
19 the basis for emerging from Chapter 11 to try to satisfy us
20 on a constituency that I believe this is viable and it can be
21 done. Didn't you revise it at our insistence?

22 A. Yes, with your assistance and also Retail Forward, we
23 mentioned earlier, that the three of us, the three groups
24 together did form a new plan that, my recollection is that we
25 all agreed, had viability.

1 Q. Okay. And didn't during some of those revisions we ask
2 you to really look very closely at some of the assumptions in
3 it to make sure that it accurately reflected expenses,
4 inventory adjustments, and other details which you eventually
5 made those revisions; isn't that true?

6 A. Yes, that would be true. We did make adjustments as
7 required.

8 Q. Okay. And would you say that we're working very hard
9 with this plan funder to try to see if we can come up with a
10 viable business plan?

11 A. I would say that overall the Committee has worked very
12 closely with the company on all these situations. I would
13 say, though, that both sides seem to have been a bit
14 distracted in the last thirty days.

15 Q. I'm not testifying, but I've been working on it every
16 day. In any event, when you say -- You heard testimony
17 earlier that we were only a million dollars apart on a plan.
18 What's the basis for you knowing that given that my firm has
19 been the party directly negotiating with this plan funder
20 about each of the things that it would need to have the
21 company emerge from bankruptcy.

22 MR. POLEBAUM: Objection, Your Honor. The question
23 is referring to testimony that was never made by Mr. McMahon.
24 I'm the person who made the statement in oral argument to the
25 Court, and it's nothing that Mr. McMahon has ever testified

1 to.

2 THE COURT: He says he can't answer the question;
3 is that right?

4 THE WITNESS: It's a complicated question.

5 THE COURT: Why don't you rephrase the question so
6 he can answer it.

7 MR. TRAUB: Certainly.

8 BY MR. TRAUB:

9 Q. You heard -- You've been in the courtroom the whole day;
10 right?

11 A. Yes, I have.

12 Q. Okay. And did you hear a representative of the debtor
13 say that they believed that we're only about a million
14 dollars apart on a plan?

15 A. That's not the exact phrase that I heard, but I
16 understand -- I was here during the testimony in which you're
17 referring to, yes.

18 Q. Okay.

19 A. Not the testimony, excuse me, the --

20 Q. Do you have any direct knowledge of the most recent
21 negotiations as to how far apart we are in a plan?

22 A. My understanding was that there was a discussion for the
23 emergence costs. We had, with the Committee, put together a
24 plan of \$26.5 million, and in that plan, that included \$3
25 million set aside for litigation. The Committee, I believe

1 countered back to this potential sponsor that that's what
2 they wanted, and the potential sponsor came back and said
3 originally \$20 million but then came back and said, we would
4 be willing to fund up to \$25 million. That's my
5 understanding.

6 Q. Those are not the only items in the plan or the term
7 sheet; are they?

8 A. That's correct.

9 Q. So, to say that we're only potentially a million dollars
10 or so apart on those items, that would not clearly set forth
11 that we may be apart by some degree on many other items; is
12 that right?

13 A. My understanding, and this is from speaking directly
14 with members of the Creditors Committee as has my CFO, that
15 there were two issues. That was one big issue. The second
16 was the terms and mechanics of the seasonal over-advance and
17 if those two issues were satisfied that the Committee had
18 said they were very supportive of, and those are from
19 individual conversations that both I and the CFO have had.
20 So, my understanding was those were the two remaining issues.

21 Q. Maybe you didn't speak to enough people, but there are
22 other open issues including the residual -- Excuse me --

23 MR. POLEBAUM: Your Honor, this is examination.
24 Mr. Traub is not asking a question. He's testifying.

25 THE COURT: Oh, sit down. Go on.